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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 506

COMTEL CORPORATION, *et al.*,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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August 16, 1967.

TABLE OF CONTENTS

	PAGE
Opinions Below	1
Jurisdiction	1
Questions Presented	2
Statutes Involved	2
Statement of the Case	2
Reasons for Granting the Writ	6
Conclusion	18
Appendix	1b

TABLE OF CITATIONS

CASES:

Ah Pah Redwood Co. v. *Commissioner*, 251 F. 2d 163, 168-9 (9th Cir. 1957) 15

Jack Ammann Photogrammetric Engineers, Inc. v. *Commissioner*, 341 F. 2d 466, 467 (5th Cir. 1965) 15, 16

Associated Indemnity Corporation v. *Scott*, 103 F. 2d 203, 209 (5th Cir. 1939) 17

Autenreith v. *Commissioner*, 115 F. 2d 856, 858 (3rd Cir. 1940) 8

Bates Valve Bag Corporation v. *Higgins*, 157 F. 2d 886, 887 (2d Cir. 1946) 14

Becker v. *Commissioner*, 277 F. 2d 146, 149 (2d Cir. 1960) 8n

PAGE

Bercaw v. *Commissioner*, 165 F. 2d 521, 525 (4th Cir. 1948) 8

Bowersock Mills & Power Co. v. *Commissioner*, 172 F. 2d 904, 907 (10th Cir. 1949) 9

Campbell v. *Carter Foundation Production Co.*, 322 F. 2d 827, 831 (5th Cir. 1963) 8

Chase Manhattan Bank v. *Commissioner*, 259 F. 2d 231, 237-238 (5th Cir. 1958) 15

Chase National Bank v. *United States*, 116 F. 2d 625, 627, 628 (2d Cir. 1940) 13

Commissioner v. *H. P. Hood and Sons, Inc.*, 141 F. 2d 467, 469, 470 (1st Cir. 1944) 8

Commissioner v. *Hopkinson*, 125 F. 2d 406, 409 (2d Cir. 1942) 14

Commissioner v. *Moore*, 48 F. 2d 526 (10th Cir. 1931), *cert. denied* 284 U. S. 620 ..... 3n

Commissioner v. *O. P. P. Holding Corp.*, 76 F. 2d 11, 12 (2d Cir. 1935) 8

Deputy v. *du Pont*, 308 U. S. 488, 497-8 (1940) .. 7

Fullerton v. *McCurdy*, 55 N. Y. 637 (1873) 7

Gilman v. *Commissioner*, 53 F. 2d 47, 50 (8th Cir. 1931) 9

Glover v. *Payn*, 19 Wend. 518 (1838) 7

Gordon v. *Commissioner*, 67-2 USTC ¶9592 (2d Cir., July 26, 1967) 15

Green v. *Commissioner*, 367 F. 2d 823 (7th Cir. 1966) 9

Guardian Investment Corp. v. *Phinney*, 253 F. 2d 326, 330, 331 (5th Cir. 1958) 8

Helvering v. *Leonard*, 310 U. S. 80, 83 (1940) ... 13

Hormel v. *Helvering*, 312 U. S. 552, 557, 558 (1941) 12, 13

PAGE

Jewel Tea Company, Inc. v. *U. S.*, 90 F. 2d 451, 453 (2d Cir. 1937) 8

Kent Manufacturing Corporation v. *Commissioner*, 288 F. 2d 812 (4th Cir. 1961) 11

Lynch v. *Commissioner*, 273 F. 2d 867, 870 (2d Cir. 1959) 8n

MacRae v. *Commissioner*, 294 F. 2d 56, 59 (9th Cir. 1961), *cert. denied* 368 U. S. 955 (1962) 15, 16

Randall v. *Sanders*, 87 N. Y. 578 (1882) 7

Roebling Securities Corp. v. *U. S.*, 176 F. Supp. 844 (D. N. J. 1959) 3n

Sherwood Memorial Garden v *Commissioner*, 350 F. 2d 225, 228 (7th Cir. 1965) 9

Smith Engineering Co. v. *Rice*, 102 F. 2d 492, 499 (9th Cir. 1938) 17

Thompson v. *Commissioner*, 235 F. 2d 599, 601 (9th Cir. 1956) 9

Towanda Textiles, Inc. v. *United States*, 180 F. Supp. 373 (Ct. Cl. 1960) 11

United States v. *Dakota Tractor & Equipment Co.*, 125 F. 2d 20, 25 (8th Cir. 1942) *cert. denied* 316 U. S. 671 .....15, 16

United States v. *Merrill*, 211 F. 2d 297, 303 (9th Cir. 1954) 15

United States v. *Midland Ross Corporation*, 381 U. S. 54, 58-9 (1965) 11n

Washmont Corporation v. *Hendricksen*, 137 F. 2d 306, 309 (9th Cir. 1943) 9

Youssoupoff v. *Widener*, 246 N. Y. 174, 158 N. E. 64 (1927) 7

PAGE

STATUTES:

28 U. S. C., Section 1254(1) 2

Internal Revenue Code of 1954

Section 337(a) 2, 4, 5, 6, 10, 11, 12

Section 871 .....11, 12

Section 871(a)(1)(C) 12

Section 1231 11

Section 1232 .....11, 12

Section 1232(a) 2

Section 1232(a)(2)(A) 6, 10, 11

Section 1232(b) 2

Section 1232(b)(1) 6, 10

Section 1238 11

Section 6213 2

Section 6214 2

Section 7482(a) 2

MISCELLANEOUS:

House Report No. 1450 (89th Cong., 2d Sess.), p. 19 12

Senate Report No. 1707 (89th Cong., 2d Sess.), p. 24 12

Rev. Rul. 54-43, 1954-1 C. B. 119 7

Rev. Rul. 56-372, 1956-2 C. B. 187 11

Rev. Rul. 59-308, 1959-2 C. B. 110 11

Rev. Rul. 64-100, 1964-1 C. B. (Part 1) 130 11

IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No.

COMTEL CORPORATION, *et al.*,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Comtel Corporation (Comtel) and the thirty other petitioners named in the printed Appendix for the Petitioners (1a)* pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding.

Opinions Below

The opinion of the Tax Court (5a-29a) is reported at 45 T. C. 294. The opinion of the Court of Appeals (pp. 5b-17b, Appendix to this petition) affirming the decision of the Tax Court is not yet officially reported.

Jurisdiction

The judgment of the Court of Appeals was dated and entered on May 4, 1967 (162a) and rehearing was denied by orders dated and entered on June 2, 1967 (185a, 188a).

*Record references, unless otherwise indicated, are to the printed Appendix for the Petitioners.

The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1) and Section 7482(a) of the Internal Revenue Code of 1954,* 26 U. S. C., Section 7482(a). The jurisdiction of the Tax Court was based upon Sections 6213 and 6214, 26 U. S. C. Sections 6213 and 6214.

Questions Presented

1. As a matter of law, can a debt exist for Federal income tax purposes if the alleged debtor does not have an unconditional legal obligation to pay money to the alleged creditor?

2. May a Court of Appeals properly refuse to consider an additional legal argument made by the appellant for the first time in that Court with respect to the interpretation of a statutory provision the meaning of which was at issue in the trial court, where that legal argument is based upon the record already made and does not require the taking of additional evidence or the making of additional findings of fact?

Statutes Involved

The statutes involved are Section 337(a) and Section 1232(a) and (b), 26 U. S. C. Section 337(a) and Section 1232(a) and (b). Such statutes are set forth in the Appendix to this petition at pages 1b-4b.

Statement of the Case

This petition seeks review of a judgment determining a deficiency in the Federal income tax of Comtel for its taxable year 1958 in the amount of $215,621.33. The thirty

*All section references, unless otherwise indicated, are to the Internal Revenue Code of 1954.

other petitioners are former stockholders of Comtel (which has been dissolved) who are liable as transferees for any deficiency in its income tax. Petitioners started this proceeding on January 11, 1963, in the Tax Court of the United States (2a). The basic facts in the case are not disputed, being almost entirely stipulated by the parties (30a-140a) and in part established by the uncontradicted testimony of one witness (141a-147a). The facts may be summarized as follows:

In February, 1958, Comtel purchased from Zeckendorf Hotels Corporation (Zeckendorf) for Zeckendorf's acquisition price ($8,264,000) over 90% of the shares of Commodore Hotel, Inc. (the Commodore shares). Zeckendorf had simultaneously acquired the Commodore shares from the public pursuant to a tender offer under which Zeckendorf had previously become obligated to purchase them.* Zeckendorf for some months prior to February, 1958, had attempted without success to borrow the money from various sources to finance its obligation under the tender offer. Both Comtel and its shareholders** had refused to loan money to Zeckendorf for that purpose (32a, 33a, 142a).

At the time of the purchase, Comtel granted Zeckendorf an option exercisable after six months to purchase the Commodore shares from Comtel for $9,136,000 (35a). Zeckendorf was not obligated to Comtel to exercise the option (144a). There was considerable doubt in February, 1958, whether Zeckendorf would be able to secure the financing

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*In substance, this was a purchase by Comtel directly from the public shareholders since Zeckendorf was merely a conduit obligated to transfer the Commodore shares to Comtel the instant they were received from the public shareholders. *Commissioner* v. *Moore*, 48 F. 2d 526 (10th Cir. 1931), *cert. denied*, 284 U. S. 620; *Roebling Securities Corp.* v. U. S., 176 F. Supp. 844 (D. N. J. 1959).

**Comtel's shareholders were Tri-Continental Financial Corporation, Eastman Dillon, Union Securities & Co., a partnership, and Zeckendorf. Each shareholder owned one-third of Comtel's stock.

which would permit it to exercise the option (145a). The agreements between the parties contained numerous provisions as to procedure if Zeckendorf did not exercise the option (37a, 53a, 54a, 73a, 98a, 117a, 118a, 119a). In June, 1958, Zeckendorf was finally able to arrange to borrow sufficient money from third parties to enable it to exercise the option (146a, 147a). Until that time Zeckendorf was not in a position to exercise the option, even if it desired to do so. In September, 1958, Zeckendorf exercised the option thus giving Comtel a profit of $872,000 (40a, 135a-137a). New York law applied to the transaction (102a).

On September 4, 1958, Zeckendorf informed Comtel that it would exercise the option on September 5, 1958. On September 4, 1958, Comtel and its stockholders adopted a plan of complete liquidation authorizing the dissolution of Comtel and the pro rata distribution of its assets to its stockholders on or before December 31, 1958. On September 5, 1958, Comtel sold the Commodore shares to Zeckendorf pursuant to the exercise of the option, discharged its liabilities and distributed its remaining assets (consisting of cash) to its stockholders in complete cancellation and redemption of their stock. In its Federal income tax return for its taxable year 1958, Comtel treated the gain of $872,000 realized upon the sale of the Commodore shares as "gain . . . from the sale or exchange by it of property" which was subject to non-recognition under Section 337(a). The stockholders of Comtel reported a capital gain upon the liquidation of Comtel. (21a, 40a, 41a).

Both Comtel and Zeckendorf intended the transactions between them to be a purchase by Comtel of the Commodore shares in February, 1958, and a sale by Comtel to Zeckendorf of the Commodore shares in September, 1958, as evidenced by the fact that the parties so treated them in all respects on their books and in their tax returns (43a).

Neither party claimed that there was a debtor-creditor relationship between them. Comtel had no indemnity against loss with respect to its investment in the Commodore shares.

The Tax Court held that even though Zeckendorf had no legal obligation to exercise the option or purchase the Commodore shares from Comtel, the transaction was "in substance" a loan of $8,264,000 by Comtel to Zeckendorf and that the $872,000 profit realized by Comtel on the exercise of the option by Zeckendorf was interest on that loan rather than gain from the sale of property. The Tax Court accordingly held that Section 337(a) was not applicable and that Comtel was taxable upon $872,000 of interest income.*

On appeal, petitioners argued that the transactions could not be held to create a debt since Zeckendorf was never legally obligated to repay to Comtel any part of the $8,264,000 which Comtel had used to purchase the Commodore shares in February, 1958. As an alternative legal position, the petitioners also argued, for the first time on appeal, that even if the Tax Court was right that Comtel had loaned Zeckendorf $8,264,000 in February, 1958, against Zeckendorf's "debt" obligation to pay $9,136,000 to Comtel in September, 1958, the $872,000 profit was not

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*The Tax Court did not find, nor could it on the evidence, that Zeckendorf was *certain* to exercise the option. Although Zeckendorf's stockholder (Webb & Knapp, Inc.) had guaranteed Comtel's stockholders (other than Zeckendorf) a profit of $43,500 if the option were not exercised, that was far less than the profit of $872,000 which Comtel realized on the exercise of the option (which Zeckendorf shared as a 33⅓% stockholder of Comtel). If the Commodore shares had not increased in value after February, 1958, it would have cost Zeckendorf at least $360,000 more to exercise the option than not to exercise it. The computations upon which that $360,000 figure is based were contained in petitioners' brief in the Court of Appeals and were not challenged by the Department of Justice. Zeckendorf was thus not economically compelled to exercise the option regardless of fluctuations in the value of the Commodore shares.

interest income but was original issue discount within the meaning of Section 1232(b)(1). The amount of original issue discount would be "gain from the sale or exchange of property" under the express terms of Section 1232(a)(2)(A) upon Zeckendorf's payment of its "debt". The "debt" would be "property" owned by Comtel and the payment of the debt would be the "sale or exchange" of that property. Accordingly, Comtel would be exempt from tax on the amount of the original issue discount since Section 337(a) exempts any "gain . . . from the sale or exchange by it of property" within the twelve-month period beginning on the date of the adoption of its plan of complete liquidation.

The Court of Appeals affirmed the Tax Court's decision that the transaction was in substance a loan by Comtel to Zeckendorf and that the $872,000 profit was interest income, even though Zeckendorf was not obligated to exercise the option. The Court of Appeals refused to consider the petitioners' alternative legal argument that the payment of the "debt" by Zeckendorf resulted in a gain from "the sale or exchange of . . . property" within the meaning of Section 337(a) on the ground that it had not been raised below. In so doing, the Court acted *sua sponte*, since the Department of Justice had not suggested (either on brief or on oral argument) that failure to raise the alternative legal argument in the Tax Court should prevent its consideration by the Court of Appeals.

Reasons for Granting the Writ

I

The Court below has decided an important question of Federal law, namely, that there may be a debt for Federal income tax purposes where the "debtor" is under no un-

conditional legal obligation to pay any money to the "creditor". Under the applicable State law the New York Court of Appeals has held that a sale of property coupled with an option to purchase that property does not create a debt. The decision of the Court below is thus in conflict with decisions of the New York Court of Appeals. It is also in conflict with decisions of this Court, of the Court below and of other Courts of Appeals.

The New York courts have held since 1838 that a sale of property coupled with an option to purchase such property does not create a debt unless the sales price is grossly inadequate (admittedly not true here). The transferee of the property becomes the absolute owner subject only to the option. *Glover* v. *Payn*, 19 Wend. 518 (1838); *Fullerton* v. *McCurdy*, 55 N. Y. 637 (1873); *Randall* v. *Sanders*, 87 N. Y. 578 (1882); *Youssoupoff* v. *Widener*, 246 N. Y. 174, 158 N. E. 64 (1927); see also Rev. Rul. 54-43, 1954-1 C. B. 119.

The decision of the Court below is in conflict with the decision of this Court in *Deputy* v. *du Pont*, 308 U. S. 488, 497-8 (1940), in which this Court stated that the terms "indebtedness" and "interest" for Federal income tax purposes have "the usual, ordinary and everyday meaning". Zeckendorf was not "indebted" to Comtel in any ordinary and everyday sense of that word. The transactions between Zeckendorf and Comtel admittedly did not create a debt for the purpose of (1) permitting Comtel to compel Zeckendorf to pay any part of it, (2) giving Comtel a provable claim if Zeckendorf has gone into bankruptcy before exercising the option, (3) giving Zeckendorf or its trustee an equity of redemption in the Commodore shares if the option had not been exercised, or (4) determining whether the usury laws were applicable. A transaction which is not a loan for any other purpose cannot be treated as in sub-

stance a loan for Federal income tax purposes. Tax law is not thus to be divorced from the general body of the law.*

The decision of the Court below is also in conflict with previous decisions of that Court, *e.g.*, *Commissioner* v. *O.P.P. Holding Corp.*, 76 F. 2d 11, 12 (2d Cir. 1935), and *Jewel Tea Company, Inc.* v. *U. S.*, 90 F. 2d 451, 453 (2d Cir. 1937). In the *Jewel Tea Company* case, *supra*, the Court stated that the *O.P.P. Holding Corporation* case, *supra*, held that a debt cannot exist unless "the holder may unconditionally demand his money at a fixed time". The Court stated (90 F. 2d at 453): "All we now decide is that in the absence of such a provision the security cannot be a debt."

The decision of the Court below is in conflict with the decisions of other Courts of Appeals which have decided that there cannot be a debt for Federal income tax purposes in the absence of an unconditional enforceable legal obligation to pay: *Commissioner* v. *H. P. Hood and Sons, Inc.*, 141 F. 2d 467, 469, 470 (1st Cir. 1944); *Autenreith* v. *Commissioner*, 115 F. 2d 856, 858 (3rd Cir. 1940); *Bercaw* v. *Commissioner*, 165 F. 2d 521, 525 (4th Cir. 1948); *Campbell* v. *Carter Foundation Production Co.*, 322 F. 2d 827, 831 (5th Cir. 1963); *Guardian Investment Corp.* v.

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*In deciding that the transactions between Comtel and Zeckendorf created a debt owing from Zeckendorf to Comtel, the Court below used an argument not made either by the Tax Court or by the Commissioner of Internal Revenue, namely, that the transactions were analogous to a nonrecourse loan (p. 16b of the Appendix to this petition). In the case of a nonrecourse loan, however, there is in terms an obligation of the debtor to pay the creditor from a particular fund or source. In the instant case, there was no such obligation. Moreover, if, on a purported purchase of property, the "purchaser" merely gives his nonrecourse note secured by the pledge of the property, it has been held that the transaction is the equivalent of an option to purchase the property rather than a purchase of the property. *Becker* v. *Commissioner*, 277 F. 2d 146, 149 (2d Cir. 1960); *Lynch* v. *Commissioner*, 273 F. 2d 867, 870 (2d Cir. 1959). The holder of an option and the maker of a nonrecourse note are both free to change their minds about the "purchase".

Phinney, 253 F. 2d 326, 330, 331 (5th Cir. 1958); *Sherwood Memorial Garden* v. *Commissioner*, 350 F. 2d 225, 228 (7th Cir. 1965); *Gilman* v. *Commissioner*, 53 F. 2d 47, 50 (8th Cir. 1931); *Washmont Corporation* v. *Hendricksen*, 137 F. 2d 306, 309 (9th Cir. 1943); *Thompson* v. *Commissioner*, 235 F. 2d 599, 601 (9th Cir. 1956); *Bowersock Mills & Power Co.* v. *Commissioner*, 172 F. 2d 904, 907 (10th Cir. 1949).

The Tax Court's decision that the transactions between Comtel and Zeckendorf were in substance a loan and created a debt was based upon its finding that Zeckendorf never wavered in its desire to acquire the Commodore shares and ultimately did exercise the option (25a). It conceded that there was no legal obligation binding Zeckendorf to exercise the option and it did not find as a fact (nor could it have done so on the record) that Zeckendorf was certain to exercise the option at the time it was given. Concededly, the Commodore shares could, in the period from February, 1958, to September, 1958, have declined sufficiently in value so that it would have been unprofitable for Zeckendorf to exercise the option. Also Zeckendorf might never have obtained the financing which enabled it to exercise the option. Yet the Tax Court did not state what the substance of the transaction would have been if the option had *not* been exercised, a possibility that might have occurred. *Cf. Green* v. *Commissioner*, 367 F. 2d 823 (7th Cir. 1966), where the Tax Court had found on the basis of testimony and correspondence between the parties that what was in form an option was actually a *firm obligation to purchase*. Such a finding is lacking in the instant case.

II

In refusing to consider the petitioners' alternative legal argument, raised for the first time on appeal, the Court below decided an important question of Federal law and

procedure contrary to the rules laid down by this Court, by previous decisions of the Court below and by a number of other Courts of Appeals.

The issue decided by the Tax Court was whether the profit of $872,000 realized by Comtel in its transactions with Zeckendorf was "gain . . . from the sale or exchange . . . of property" which was exempt from tax under Section 337(a). The Tax Court held that the transaction was in substance a loan by Comtel of $8,264,000 to Zeckendorf against Zeckendorf's debt to Comtel in the amount of $9,136,000. It then held that the profit of $872,000 which Comtel realized on the collection of that debt was interest income rather than gain from the sale or exchange of property and hence was not subject to the non-recognition provisions of Section 337(a). In other words, the Tax Court held that Comtel had never been the owner of the Commodore shares and that the only property which Comtel owned was a debt owing to it by Zeckendorf. If, as held by the Tax Court, Comtel had acquired for $8.264,000 the obligation of Zeckendorf to pay it $9,136,000, the difference between the sums would concededly be original issue discount as defined in Section 1232(b)(1). Section 1232(a)-(2)(A) expressly provides that original issue discount when realized by the taxpayer upon the payment of a debt must "be considered as gain from the sale or exchange of property which is not a capital asset". Section 337(a) in turn requires the non-recognition of "gain . . . from the sale or exchange . . . of property". Accordingly, the petitioners' alternative argument which was raised for the first time on appeal was merely an additional legal argument in support of the issue which was before the Tax Court, namely, whether the $872,000 profit realized by Comtel was a gain from the sale or exchange of property under Section 337(a). It was based upon the record already made below and did not require any additional findings of fact.

Section 1232 is contained in Part IV of Subchapter P (Sections 1231-1250) which is entitled "Special Rules for Determining Capital Gains and Losses". While there is as yet no court decision* or ruling that what is treated as a "gain from the sale or exchange of property which is not a capital asset" under Section 1232(a)(2)(A) should be treated as a gain from the sale or exchange of property under Section 337(a), analogous cases and rulings indicate that what Congress has treated as gains from the sale or exchange of property in Part IV of Subchapter P are also to be treated as gains from the sale or exchange of property for the purposes of Section 337(a). For example, under Section 1231, income from an involuntary conversion of property is treated as gain from the sale or exchange of property and hence is entitled to be treated as gain from the sale or exchange of property under Section 337(a). *Towanda Textiles, Inc.* v. *United States*, 180 F. Supp. 373 (Ct. Cl. 1960); *Kent Manufacturing Corporation* v. *Commissioner*, 288 F. 2d 812 (4th Cir. 1961); Rev. Rul. 64-100, 1964-1 C. B. (Part 1) 130, revoking Rev. Rul. 56-372, 1956-2 C. B. 187. The Internal Revenue Service has also ruled that gain from the sale of an emergency facility which, under Section 1238, is considered as gain from the sale or exchange of property which is not a capital asset is to be treated as gain from the sale or exchange of property under Section 337(a). Rev. Rul. 59-308, 1959-2 C. B. 110.

Because Section 871 of the Code does not tax non-resident aliens on gains from the sale or exchange of property, Section 1232(a)(2)(A) prevented non-resident aliens from being taxed on original issue discount since such dis-

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*This Court in *United States* v. *Midland Ross Corporation*, 381 U. S. 54, 58-9 (1965), considered the taxability of original issue discount under the Internal Revenue Code of 1939 but refused to speculate on the meaning of Section 1232(a)(2)(A) which was not before it (p. 59n).

count was considered as a gain from the sale or exchange of property. Non-resident aliens are, however, taxed on "interest". In order to tax non-resident aliens on original issue discount, Congress amended Section 871 in 1966 specifically to provide in Section 871(a)(1)(C) that the taxable income of non-resident aliens includes

> "(C) in the case of bonds or other evidences of indebtedness issued after September 28, 1965, amounts which under section 1232 are considered as gains from the sale or exchange of property which is not a capital asset".

See House Report No. 1450 (89th Cong., 2d Sess.), page 19; Senate Report No. 1707 (89th Cong., 2d Sess.), page 24.

The Department of Justice in its brief in the Court below argued that what is considered as a "gain from the sale or exchange of property which is not a capital asset" under Section 1232 could not be considered "gain . . . from the sale or exchange . . . of property" under Section 337(a). The Department also contended on oral argument that Section 337(a) did not apply to exempt from tax gain from the sale or exchange of property which is not a capital asset. Those arguments are completely refuted by the cases and the rulings of the Internal Revenue Service above cited. Accordingly, the additional legal argument urged by the petitioners before the Court of Appeals was a substantial one and was not frivolous.

The refusal of the Court below to consider an additional legal argument addressed to the issue which was before the Tax Court is in conflict with the rule laid down by this Court in *Hormel* v. *Helvering*, 312 U. S. 552, 557, 558 (1941). There this Court stated:

> "Rules of practice and procedure are devised to promote the ends of justice, not to defeat them.

> A rigid and undeviating judicially declared practice under which courts of review would invariably and under all circumstances decline to consider all questions which had not previously been specifically urged would be out of harmony with this policy. Orderly rules of procedure do not require sacrifice of the rules of fundamental justice." (p. 557)

In stating "the philosophy which underlies this Court's decisions with relation to appellate practices," this Court referred to cases presenting a situation similar to that presented by the instant case as "those which have been remanded because the lower courts failed to give consideration to a phase of the case involving legal theories not presented" (p. 558). See also *Helvering* v. *Leonard*, 310 U. S. 80, 83 (1940).

The Court below, prior to the instant case, followed the rule laid down by this Court in the *Hormel* case, *supra*, and, where the interpretation of a particular section of the Internal Revenue Code was at issue before the trial court, has permitted a legal argument as to the interpretation of that section to be made for the first time on appeal, even though not made in or considered by the trial court, where no additional findings of fact were required. In *Chase National Bank* v. *United States*, 116 F. 2d 625, 627, 628 (2d Cir. 1940), the interpretation of Section 302(g) of the Revenue Act of 1926 was involved. The appellant relied upon an additional legal argument as to the interpretation of that section which was not made below. The Court considered that argument over the opposition of the appellee and reversed the trial court saying:

> "Nevertheless at all times it relied on the provisions of Section 302(g) as the basis for taxation and is now simply giving new reasons to show that Section

> 302(g) is applicable. It is quite impossible to suppose that a new reason for the application of a statute always relied on may not be considered by this court because of the ruling in Helvering v. Wood, 309 U. S. 344, 60 S. Ct. 551, 84 L. Ed. 796. Indeed, in Helvering v. Leonard, 310 U. S. 80, 60 S. Ct. 780, 84 L. Ed. 1087, the Supreme Court did the very thing the government is asking us to do here. It decided that Section 22(a) of the Revenue Act rendered certain income of a trust taxable against the settlor and reached this conclusion upon an argument first made before it which had not been presented to the court below." (pp. 627-628)

Similarly, in *Commissioner* v. *Hopkinson,* 126 F. 2d 406, 409 (2d Cir. 1942), the appellant for the first time on appeal relied upon a new legal argument. The Court upheld the appellant's right to do so, stating:

> "He did not rely upon this contention before the Board but wishes to do so now. We think that is permissible under Hormel v. Helvering, 312 U. S. 552, 61 S. Ct. 719, 85 L. Ed. 1037, as the respondent has been put to no disadvantage by way of surprise; has filed, by leave, a supplemental brief covering that issue; and no facts not already of record are required for decision." (p. 409)

In *Bates Valve Bag Corporation* v. *Higgins,* 157 F. 2d 886, 887 (2d Cir. 1946), the Court below also permitted an additional legal argument to be made by the appellant for the first time on appeal, saying:

> "The appellee's objection to the argument that the corporation was not bound by any contract pro-

> vision not to declare dividends payable in its obligations because made here for the first time is unsound. The issue below was, as it is here, whether the taxpayer was by contract disenabled to pay dividends to such an extent and in such a way that it was entitled to the credits now claimed. The argument presents a new thought, but not a new issue and could be used on appeal to give added support to the position taken by the appellant below." (p. 887)

Since the instant case was decided, a different panel of the Court below has considered, as a matter of course, a new legal argument not raised in the Tax Court. *Gordon* v. *Commissioner*, 67-2 USTC ¶ 9592 (2d Cir., July 26, 1967), not yet officially reported. That case involved the application of Section 355 to the distribution by a corporation to its shareholders of stock of a subsidiary. The Commissioner was permitted to raise for the first time on appeal the additional legal argument that the distribution of the subsidiary's stock had been made in two parts rather than as a single distribution.

The decision of the Court below is also in conflict with decisions of the Courts of Appeals for the Fifth, Eighth and Ninth Circuits in *Chase Manhattan Bank* v. *Commissioner*, 259 F. 2d 231, 237-238 (5th Cir. 1958); *Jack Ammann Photogrammetric Engineers, Inc.* v. *Commissioner*, 341 F. 2d 466, 467 (5th Cir. 1965); *United States* v *Dakota Tractor & Equipment Co.*, 125 F. 2d 20, 25 (8th Cir. 1942), *cert. denied* 316 U. S. 671; *Ah Pah Redwood Co.* v. *Commissioner*, 251 F. 2d 163, 168-9 (9th Cir. 1957); *MacRae* v. *Commissioner*, 294 F. 2d 56, 59 (9th Cir. 1961), *cert. denied* 368 U. S. 955 (1962); and *United States* v. *Merrill*, 211 F. 2d 297, 303 (9th Cir. 1954).

In *Jack Ammann Photogrammetric Engineers, Inc.* v. *Commissioner, supra,* the Court of Appeals for the Fifth Circuit stated:

> "Here, petitioner makes a several-pronged attack on the Tax Court decision. Since these are legal theories that can be fairly disposed of on the record before us, we do not consider that we should refuse to consider them merely because they were not urged in the Tax Court. Chase Manhattan Bank v. Commissioner of Internal Revenue, 5 Cir., 259 F. 2d 231." (p.467)

In *United States* v. *Dakota Tractor & Equipment Co., supra,* the Court of Appeals for the Eighth Circuit permitted an appellant to raise a new legal argument on appeal even though it was not raised in the trial court and the appellee objected to its consideration. The Court said:

> "Appellee challenges the right of appellant to present this issue because it was not raised in the trial court. Hormel v. Helvering, 312 U. S. 552, 61 S. Ct. 719, 85 L. Ed. 1037 (Helvering v. Hormel, 8 Cir., 111 F. 2d 1, this Court) rules otherwise. We consider the merits of this contention." (p. 25)

So also in *MacRae* v. *Commissioner, supra,* the Court of Appeals for the Ninth Circuit stated:

> "The Commissioner contends that we should not consider on this appeal such alternate grounds because they were not raised in the pleadings before the Tax Court. . . . The claimed deduction for out-of-pocket losses arises out of the same transactions which were considered by the Tax Court. No new fact issues are presented, and it is not necessary to

> go beyond the findings of the Tax Court to consider the propriety of the claimed deduction. The Commissioner is not prejudiced, nor has he been denied the opportunity to present arguments against allowance thereof. Under these circumstances, we believe that justice requires that we pass upon the merits of taxpayer's contentions." (p. 59)

The question of Federal law and procedure involved in the instant case, namely, whether a case may be decided by an appellate court without consideration of legal arguments of the appellant which were not raised below (and which, if sound, would require reversal) goes far beyond the tax field in which the instant case arises. Two relevant quotations from non-tax cases which indicate the reasons why we believe this Court should remand this case to the Court below for consideration of petitioner's additional legal argument are as follows:

> ". . . where, as here, the case below was tried, not upon any misapprehension of the facts, but upon a misapprehension of the effect of those facts in law, appellant may not be prevented from pressing here for the application, to the proven facts, of the correct principles of law." *Associated Indemnity Corporation* v. *Scott,* 103 F. 2d 203, 209 (5th Cir. 1939).

> "We see no reason why we should make what we think would be an erroneous decision, because the applicable law was not insisted upon by one of the parties." *Smith Engineering Co.* v. *Rice,* 102 F. 2d 492, 499 (9th Cir. 1938).

In refusing *sua sponte* to consider an additional legal argument not made below, the Court of Appeals has so far departed from the accepted and usual course of judicial

proceedings as to call for an exercise of this Court's power of supervision. The refusal of the Court below to consider a substantial legal argument of the petitioners has deprived them of justice. If that argument should prevail, no tax would be payable. This Court should remand this case to the Court below with instructions to consider petitioners' additional legal argument.

Conclusion

For the foregoing reasons, this petition for certiorari should be granted.

Respectfully submitted,

GEORGE G. TYLER,
Counsel for Petitioners,
1 Chase Manhattan Plaza,
New York, N. Y. 10005.

August 16, 1967.

APPENDIX

Statutes Involved

Internal Revenue Code of 1954:

Section 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) *General Rule.*—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

Section 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or Exchange.*—

(A) *General Rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b)), or

(ii) if at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than six months.

(B) *Exceptions.*—This paragraph shall not apply to—

(i) obligations the interest on which is not includible in gross income under section 103 (relating to certain governmental obligations), or

(ii) any holder who has purchased the bond or other evidence of indebtedness at a premium.

(C) *Double Inclusion in Income Not Required.*—This section shall not require the inclusion of any amount previously includible in gross income.

(b) *Definitions.*—

(1) *Original Issue Discount.*—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) *Issue Price.*—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond increased by the amount, if any, of tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments

made by the purchaser under the purchase agreement, including modifications thereof.

(3) *Issue Date.*—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "date of original issue" means the date on which the issue was first sold to the public at the issue price. In the case of privately placed issues of bonds or other evidences of indebtedness, the term "date of original issue" means the date on which each such bond or other evidence of indebtedness was sold by the issuer.

Opinion of the Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 215—September Term, 1966.

(Argued February 21, 1967 Decided May 4, 1967.)

Docket No. 30791

COMTEL CORPORATION, *et al.*,

Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

FRIENDLY, ANDERSON and FEINBERG,

Circuit Judges.

Taxpayers Comtel Corporation and its transferees in liquidation petition for review of a decision of the Tax Court, Allin H. Pierce, *J.*, 45 T. C. 294 (1965), holding that the substance of a transaction was a loan, though its form was a purchase and resale, and that its substance was controlling. Affirmed.

GEORGE G. TYLER, New York, N. Y. (Cravath, Swaine & Moore, David G. Ormsby, on the brief), *for Petitioners.*

Opinion of the Court of Appeals for the Second Circuit

CROMBIE J. D. GARRETT, Washington, D. C. (Mitchell Rogovin, Assistant Attorney General; Lee A. Jackson, Harold C. Wilkenfeld, on the brief), *for Respondent.*

FEINBERG, *Circuit Judge*:

This is an appeal from a decision of the Tax Court, 45 T. C. 294 (1965), holding Comtel Corporation and various transferees of its assets in liquidation liable for an income tax deficiency of $215,621.33.[1] The Tax Court held that the substance of the sole transaction Comtel engaged in during its corporate life was a loan, although the form was a stock purchase and resale, and that the substance controls. The effect of the decision was to deem Comtel the recipient of interest income taxable at the ordinary corporate income rate, rather than the beneficiary of nonrecognition treatment under section 337 of the Internal Revenue Code of 1954.[2] We affirm the Tax Court.

Most of the underlying facts—although not the significant one of intent—are stipulated and extensively set forth in the Tax Court's opinion. More briefly, they are as follows: In 1957, Zeckendorf Hotels Corporation ("Zeckendorf")[3] wanted to acquire the Hotel Commodore, then operated under a ground lease by Commodore Hotel, Inc., a publicly held corporation. Zeckendorf was unable to convince that corporation to part with its hotel; accordingly,

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[1]The transferee petitioners are 2 of Comtel's corporate former stockholders; 28 partners of Comtel's third former stockholder, Eastman Dillon, Union Securities & Co.; and the estate of such a deceased partner.

[2]Hereinafter cited by section only.

[3]Then 9113 Corporation, and a wholly-owned subsidiary of Webb & Knapp, Inc., whose moving force was William Zeckendorf.

in October of that year, Zeckendorf made a public tender offer, hoping to attract sufficient shares to merge Commodore Hotel, Inc. into Zeckendorf. By February 6, 1958, Zeckendorf had been tendered over ninety-one per cent of the Commodore stock, and by the terms of its offer, was bound to purchase it, an obligation guaranteed by Zeckendorf's parent Webb & Knapp, Inc. as well. However, Zeckendorf had been unable, despite its attempts in late 1957 and early 1958, to borrow enough cash to honor the tenders, even with Webb & Knapp's guarantee. While shopping for a loan, Zeckendorf approached the principals of what became Comtel Corporation. But they too refused to loan Zeckendorf the money necessary to acquire the Commodore stock. However, they did come to a formally different understanding, memorialized in various interrelated documents executed on February 10 and 11, 1958. What transpired pursuant to this agreement—much simplified and in respondent's formal terms—follows: Comtel Corporation was formed with $1,900,000 capital paid in equally in cash by its three equal stockholders—Tri-Continental Financial Corporation ("Tri-Fi"), Eastman Dillon, Union Securities & Co., and a Zeckendorf nominee. Comtel, in turn, secured a loan of $6,763,855 from the Irving Trust Company, at six per cent per annum, on the strength of a guarantee by a realty corporation controlled by Roger L. Stevens, the fourth principal in this transaction, and the only one not a stockholder in Comtel.[4]

Next, with Comtel's cash, Zeckendorf simultaneously acquired the Commodore stock and "sold" it to Comtel for exactly its purchase cost. At the same time, Comtel gave

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[4]Stevens received $50,000 for arranging the loan, and one of his corporations earned $120,000 upon consummation of the rest of the transaction, all ultimately paid by Zeckendorf.

back to Zeckendorf an exclusive "option" to repurchase the Commodore stock during the period August 15-September 2, 1958, slightly more than six months from the date of the agreement. The terms of Zeckendorf's repurchase option price were fixed as the total of: (a) the price Comtel paid Zeckendorf for the shares; (b) the interest cost of the Irving Trust loan; (c) a six per cent per annum return on the capital investment of the shareholders in Comtel; (d) all of Comtel's expenses connected with its organization and dissolution and incurred in purchasing and reselling the Commodore stock;[5] and finally, (e) the lump sum of $600,000. (Zeckendorf, of course, would get back the third of Comtel's net profit on the sale allocable to the shares held by its nominee.) In essence, if the option were exercised, the two shareholders in Comtel other than Zeckendorf in the space of six or seven months would get back their $1,266,667 capital with a net pre-tax return of six per cent per annum thereon plus $400,000 (two-thirds of $600,000).[6]

Under the terms of the agreement, Eastman Dillon's and Tri-Fi's risk of loss was practically eliminated. These security arrangements were included in the arrangement: Zeckendorf's Comtel stock was subordinated to the prior right of payment of the other shareholders' stock, and Zeckendorf and Webb & Knapp guaranteed directly to these shareholders the same full payment of their investment contained in the stock subordination provisions. Full payment of the investment of the other two shareholders was defined as: (a) all capital they invested in Comtel; (b) a return of six per cent per annum on that capital; (c) all

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[5]Including $120,000 to Stevens's corporation.

[6]Later reduced to $320,000, ⅔ of $480,000; see *infra*.

expenses incurred by these stockholders in connection with their investment. In other words, whether or not Zeckendorf exercised its option, the subordination agreement and the indemnity agreement assured Eastman Dillon and Tri-Fi the return of their capital plus a net pre-tax return thereon of six per cent per annum.

During the period before its option matured, Zeckendorf was at last able to obtain a long term loan—from Evelyn J. Lubin, wife of a New York realtor. It then notified Comtel of its intention to exercise its rights. However, it was subsequently discovered that since some of the Commodore stock had been acquired within six months of the agreed exercise period, purchase then might bring into play section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78p(b), depriving Comtel of its profit.[7] Therefore, the Comtel-Zeckendorf agreement was renegotiated. In substance, only three changes were made. The Irving Trust loan was prepaid and replaced by a loan to Comtel by Mrs. Lubin—at the increased rate of thirteen percent per annum, also to be paid by Zeckendorf as part of the option price. The lump sum element of the option price was reduced from $600,000 to $480,000. And finally, the exercise period of the option was postponed to a time safely beyond the critical six month period.

The new initial exercise date was September 5, 1958; on that day and the day before, the remaining relevant events occurred. Upon Zeckendorf's notification on September 4 that it would purchase, Comtel adopted a plan of complete liquidation authorizing dissolution and distribution

[7]Section 16(b) provides in essence that if any officer, director or beneficial owner of more than 10% of a corporation's stock purchases and sells any such stock within a 6 month period, any profit automatically inures to the corporation.

of all corporate assets, and Comtel's shareholders approved it. On September 5, Zeckendorf acquired the Commodore shares, tendering full payment, and immediately effected a statutory merger of Commodore into Zeckendorf; Comtel paid its remaining liability, and, finally, by the end of the day, Comtel had completely liquidated and made a final liquidation distribution to its stockholders, entirely in cash. It is that liquidation which is the basis of transferee liability here.

Comtel Corporation treated its gain of $872,028.79 as not requiring recognition under section 337, and its transferee stockholders all reported a capital gain upon Comtel's liquidation. It is the Commissioner's contention that this transaction, although in the form of a purchase and resale, was in substance a loan from Comtel to Zeckendorf and that, therefore, the nonrecognition provisions do not apply, and the gain must be treated as interest income and taxed at ordinary rates to Comtel.

The Tax Court stated the issue[8] before it in these terms (45 T. C. at 304):

> What was the true legal nature of the transactions betwen Comtel Corp. and Zeckendorf Hotels Corp., that resulted in Comtel's realization of undisputed gain or profit of $872,028.79—which Comtel now contends is not recognizable for income tax purposes? Did these transactions actually represent a *purchase* by Comtel from Zeckendorf of the complete beneficial and legal ownership of nearly all the outstanding shares of Commodore Hotel, Inc.—followed a few

[8]There was an alternative issue before the Tax Court, which it—as do we—found unnecessary to decide: Was Comtel a "collapsible corporation" under § 341(b), precluding it from nonrecognition under § 337?

> months later by a *sale back to Zeckendorf* of the same interest in these identical shares at a greatly increased price? Or on the other hand, were these transactions, in substance and reality as distinguished from form, merely steps in a complex, prearranged financing plan: Under which Comtel temporarily supplied funds to Zeckendorf for meeting an existing obligation to buy said Commodore shares; under which Comtel held said shares as security for its loan; and under which Zeckendorf then repaid the loan in full, together with additional prearranged amounts which were in the nature of interest on money loaned and compensated for financial services rendered?

The Tax Court concluded that this entire transaction was in substance and reality a seven-month loan, in which Zeckendorf was loaned over $8,000,000 in cash and paid interest of over $872,000.[9] It is conceded that all the documents involved and all the books of account of both Comtel and Zeckendorf treat the transaction as a purchase and resale by Comtel and that transfer taxes were paid on each phase of the transaction.[10] The Tax Court weighed these factors but found them wanting.

In overturning the consistent formal pattern of purchase and resale, the Tax Court relied on various circumstances: First, it found that Zeckendorf never wavered in its desire to acquire the Commodore stock and ultimately did achieve

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[9]However, under the various agreements a portion of this amount would eventually be returned to Zeckendorf in its capacity as stockholder of Comtel, thus apparently reducing the effective annual rate of interest to about 15%.

[10]Apparently, this expense was borne by Zeckendorf both as seller and purchaser, since it was obligated to pay Comtel's expenses in acquiring and selling the stock.

its objective, and never intended to and did not surrender complete ownership of the Commodore shares to Comtel. Second, Tri-Fi and Eastman Dillon were primarily interested in making a high yield, risk proof investment, not in embarking on hotel operation. Third, Comtel's rights in the Commodore stock during the period Zeckendorf's option was outstanding were similar to those of a mortgagee; *e.g.*, Comtel was not permitted to sell or dispose or pledge the shares (except to Irving Trust Company). Fourth, the profit from the option was not intended to result from appreciation in value of the Commodore shares or from operation of the hotel, but from the prearranged fixed option price. Fifth, the option was of short duration, and Zeckendorf could exercise it merely by paying a sum which looks just like interest and compensation for financing services on a purchase-money mortgage. Finally, though concededly there was no legal obligation binding Zeckendorf to exercise its option, the Tax Court found that realistically Zeckendorf was compelled to do so. Otherwise, through the subordination agreement, Zeckendorf might lose the $633,000 capital investment it made in Comtel, through the indemnity agreement Webb & Knapp might lose an even greater amount, and in addition Zeckendorf would lose the benefits of all its efforts and expenses in arranging the Commodore stock acquisition, negotiating the Comtel deal, and planning for the subsequent statutory merger of Commodore Hotel, Inc. into itself.

Petitioners take serious issue with each of the Tax Court's bases for ignoring the formal nature of the transaction. Thus, they claim that it is irrelevant whether Zeckendorf always hoped to acquire the Commodore stock; what counts is whether it was in a position to do so. In this respect, petitioners note that it was stipulated that

Zeckendorf could not get a loan when this deal was arranged and was able to do so only months later. Similarly, they say that it is not significant that Eastman Dillon and Tri-Fi preferred to get a high yield on an investment rather than become hotel operators through Comtel, since their wish had no effect on whether Zeckendorf would exercise the option or not, nor did it change Comtel's rights in the Commodore stock nor did it create a debt owed by Zeckendorf to Comtel. Again, they point out that Comtel's agreement not to sell or encumber the Commodore stock is entirely consistent with an option agreement covering unique property; such an agreement is not like a mortgage because the vital element of a debt owing is absent. In addition, that the option duration was prearranged and short and the price fixed in advance are not controlling; almost all options fix the price in advance and run for a prearranged period, and many run for only just over six months. Finally, petitioners level their biggest attack on the Tax Court's finding that from a practical standpoint, if not legally, Zeckendorf was compelled to exercise its option rights. Thus, they present computations to show that unless there had been an appreciation in the value of the Commodore shares from their original cost to Zeckendorf through the tender it would have been bad business to exercise the option.

We are not called upon to consider individually each of these volleys back and forth or even to weigh the whole in the first instance; the Tax Court has already done the latter. Ordinarily, it is said, we pass upon decisions of the Tax Court under a "quite restricted" standard of review—at least as to determinations of fact—*Commissioner* v. *Duberstein*, 363 U. S. 278, 290 (1960), and the observation of the Court there would seem pertinent (*id.* at 289):

> Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the main springs of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

While *Miller* v. *Commissioner*, 327 F. 2d 846 (2d Cir.), cert. denied, 379 U. S. 816 (1964) (dictum), indicated that less reliance may be placed on factual findings of the Tax Court when they do not resolve credibility of live witnesses, we do not read that case as suggesting that the Supreme Court's language quoted in text is irrelevant here. See *Fanning* v. *Conley*, 357 F. 2d 37, 42 & n. 15 (2d Cir. 1966). However, petitioners urge that the issue before us is one of law only, so that we are not limited in our review. We do not propose to enter the debate of whether the Tax Court's conclusions were in part "factual inferences" from stipulated facts, see *Weddle* v. *Commissioner*, 325 F. 2d 849, 851 (2d Cir. 1963)—as would appear to be the case—or purely conclusions of law. For we have carefully examined the record and the Tax Court's ultimate holding that the transaction here was essentially a loan rather than a sale and we see no adequate reason to disturb it.

Certainly, the perception of substance over form is no novelty in this area of the law. In *Commissioner* v. *Court Holding Co.*, 324 U. S. 331, 334 (1945), the Court said:

> To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

In that case the Tax Court was affirmed in finding a sale by a corporation despite the form of a sale by stockholders. Other cases reflect similar analysis, whether divining the substance benefited the taxpayer, *see Frelbro Corp.* v. *Commissioner*, 315 F. 2d 784, 786 (2d Cir. 1963), or the Commissioner. In *Gilbert* v. *Commissioner*, 262 F. 2d 512 (2d Cir.), cert. denied, 359 U. S. 1002 (1959), this court affirmed the conclusion of the Tax Court that advances to a corporation—though in form loans—were in substance capital contributions. *Accord, American-La France-Foamite Corp.* v. *Commissioner*, 284 F. 2d 723 (2d Cir. 1960), cert. denied, 365 U. S. 881 (1961). Similarly, in *Raleigh Properties, Inc.*, 21 CCH Tax Ct. Mem. 812 (1962), appeal to 4th Cir. dismissed by stipulation (Apr. 19, 1963), a buyer at an inflated "price" to be paid over eleven years received the benefit of an interest deduction for that part of the "price" which was in substance interest for use of the remainder of the "purchase price."[11] Here, Zeckendorf "sold" shares of stock and "bought" them back seven months later at a price of more than $872,000.00[12] over the original price. By analogy, it is a permissible—even persuasive—inference that the substantial increase in price (fixed in advance) in such a short period was to compensate for the use of over eight million dollars.

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[11]Conversely, the seller in the same transaction lost in an attempt to establish a capital gain for the full amount in *Estate of Berry*, 43 T. C. 723 (1965), aff'd per curiam, 372 F. 2d 476 (6th Cir. 1967).

[12]Or approximately $730,000 net to Zeckendorf after Comtel's liquidation distribution.

Moreover, the fact that Zeckendorf had no formal legal obligation to Comtel to repay the money used does not necessarily prevent characterizing the transaction as essentially a loan. Loans are not unknown in which the lender agrees, in the event of default, to look only to collateral for repayment, and not to the borrower. The computations offered by petitioners are designed to show that there was no economic compulsion on Zeckendorf to exercise the option; according to those figures, if the value of the Commodore shares remained the same between February 1958 (grant of option) and September 1958 (exercise of option), exercising the option cost Zeckendorf more money than letting it lapse. But if this were the only—or the most significant—consideration, Zeckendorf would not have obtained the option in the first place. What the computations ignore and what the Tax Court recognized is that Zeckendorf wanted the Hotel Commodore—obviously because of its potential—and never intended to give it up.

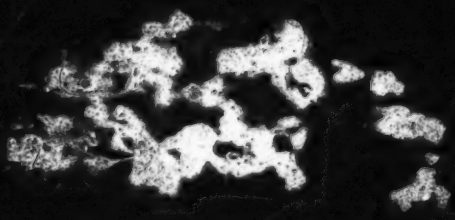
The Tax Court had the power—indeed the duty—to look to the substance of this transaction; it viewed Comtel as having the real business purpose of converting a loan with security, which would produce interest income, into a hoped-for nonrecognition situation under section 337 and ultimately a capital gain. *Gregory* v. *Helvering*, 293 U. S. 465 (1935). Each of these cases must turn on its own facts and the decision of the Tax Court on these was not unjustified. Cf. *Green* v. *Commissioner*, 367 F. 2d 823 (7th Cir. 1966); affirming the Tax Court on analogous facts. We have considered all of petitioners' arguments and authorities. Looking at the "total effect" of what occurred, see *Commissioner* v. *P. G. Lake, Inc.*, 356 U. S. 260, 266-67 (1958), we do not feel that the Tax Court was wrong in characterizing the entire transaction as not a sale, but a

short-term financing scheme in which Comtel received ordinary income.

Petitioners also argue that even if the transaction is properly regarded as a loan by Comtel to Zeckendorf of $8,264,000 in February 1958, and a promise by Zeckendorf to pay Comtel $9,136,000 in September, there would still be no interest income to Comtel. Their theory is that Zeckendorf would have issued its obligation of $9,136,000 at a discount of $872,000, and Comtel's $872,000 gain would be original issue discount under section 1232(b) (1). They go on to argue that since original issue discount is considered "gain from the sale or exchange of property," original issue discount is "gain" subject to nonrecognition under section 337. This point was not raised by petitioners in the full proceedings below, even on their motions for review by the full Tax Court or for reconsideration. Moreover, petitioners devote but a paragraph of their twenty-two page brief[18] in bare bone explication and cite no authority in support of their novel contention. Under these circumstances, we feel justified in not considering the matter further. *See Hormel* v. *Helvering*, 312 U. S. 552, 556 (1941); *Jockmus* v. *United States*, 335 F. 2d 23, 30 (2d Cir. 1964); *Dall* v. *Commissioner*, 228 F. 2d 526 (2d Cir. 1955) (*per curiam*).

Judgment affirmed.

[18] And not a line in their reply brief.



In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 506

COMTEL CORPORATION, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The primary question in this case is the proper characterization for federal income tax purposes of the sole transaction in which Comtel engaged during the seven-month period of its corporate existence. The Tax Court and the court of appeals found that the transaction, cast in the form of a sale and an option to repurchase, in substance and reality was a pre-arranged financing plan through which Comtel advanced Zeckendorf Hotels Corporation more than $8,000,000 and received more than $872,000 compensation in the nature of interest (R. 22a; Pet. App. 6b, 11b).[1] On the basis of this critical finding of fact, the

[1] "R." references are to the separately bound Appendix to Petitioners' brief in the court of appeals.

276-821—67

Tax Court rejected petitioners' contention that the transaction was a sale, and that Comtel's immediate distribution of the proceeds in liquidation qualified for the nonrecognition benefits of Section 337(a) of the Internal Revenue Code of 1954. The court of appeals, on the basis of its own exhaustive review of the record, affirmed.

The concurrent findings of the lower courts find ample support in the record and should be considered final here. There is no conflict of decisions or any other matter that warrants further appellate review.

1. In determining whether a transaction is a sale or a loan, the governing factor is, of course, the intention of the parties, and this is to be gathered not only from the instruments underlying the transaction but from all the attendant facts and circumstances. The facts and circumstances here justify—if not compel—the lower courts' conclusion that the transaction was in substance a loan. Zeckendorf at all times intended to "repurchase" the Commodore shares (R. 32a, 33a). These shares were subject to such restrictions as to their disposition by Comtel as to make their title in Comtel in all essential characteristics equivalent to a security transaction with Comtel and Zeckendorf as mortgagee and mortgagor, respectively (R. 35a, 93a–94a). Comtel sought profit not from the appreciation in value resulting from the operation of the hotel, but rather from the previously fixed "repurchase" price; the investors in Comtel were interested in a high yield, short term, risk-proof investment and not in owning or dealing in stock or managing hotels (R. 26a). To ensure the investors against loss on the transaction,

Zeckendorf was required to invest $633,000 of its own money in Comtel (R. 48a–49a) and to subordinate its right to repayment to prior payment in full of the investments of the other two shareholders, including interest at 6% and any expenses incurred (R. 33a, 56a–57a). Webb & Knapp, Zeckendorf's corporate parent, agreed to indemnify Comtel's shareholders against any loss, again including interest and expenses (R. 34a). The option was of short duration, and Zeckendorf could exercise it merely by paying a sum, the appearance of which is identical to interest and compensation for financing services on a purchase money mortgage (R. 16a–18a).

Virtually every argument advanced by the petitioners below, as here, focuses upon the "purchase" agreement of February 11, 1958 (R. 35a, 86a, 104a), under which legal title to the Commodore shares passed to Comtel. But this was only one of five agreements that the petitioners executed on that and the following day. In effect, Comtel would urge the Court to ignore the fact that each and every one of those agreements depended for its existence upon the existence of *all* the agreements and that the birth and demise of Comtel itself was the product of all the agreements. Through its concentration on the purchase agreement, Comtel has sought to divert the courts' attention from the entire financing arrangement which is comprised of the five interrelated agreements. It is the over-all effect of these documents upon which the answer to this case must be based, *United States* v. *Bethlehem Steel Corp.*, 315 U.S. 289, as the lower courts correctly ruled.

Petitioners are mistaken in their claim that the decision below, that there was a debt in the absence of a promise to repay, conflicts with the decisions of this and other state and federal courts (Pet. 6–9). Each of those cases turned on its own facts [2] and accordingly presents no conflicting issues of law.

[2] In two of the cases there was no proof that the transaction was different than evidenced by the formal conveyance and option to repurchase. *Glover* v. *Payn*, 19 Wend. 518; *Fullerton* v. *McCurdy*, 55 N.Y. 637. In *Youssoupoff* v. *Widener*, 246 N.Y. 174, and *Washmont Corporation* v. *Hendricksen*, 137 F. 2d 306 (C.A. 9), the courts held that the form of a transaction should have weight in determining the intention of the parties. In several of the cases the courts held the transactions to be illusory. *Autenreith* v. *Commissioner*, 115 F. 2d 856 (C.A. 3); *Bercaw* v. *Commissioner*, 165 F. 2d 521 (C.A. 4); *Gilman* v. *Commissioner*, 53 F. 2d 47 (C.A. 8). In *Bowersock Mills & Power Co.* v. *Commissioner*, 172 F. 2d 904 (C.A. 10), the court stressed, as we have done here, *supra*, that the whole pattern of agreements between the parties should be considered. In the following cases, in the presence of conflicting evidence, the courts found that the evidence supported the finding that an indebtedness existed. *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. 2d 11 (C.A. 2); *Commissioner* v. *H. P. Hood and Sons, Inc.*, 141 F. 2d 467 (C.A. 1); *Campbell* v. *Carter Foundation Production Co.*, 322 F. 2d 827 (C.A. 5). In others, the evidence supported findings that no indebtedness existed. *Randall* v. *Sanders*, 87 N.Y. 578; *Jewel Tea Company, Inc.* v. *United States*, 90 F. 2d 451 (C.A. 2); *Sherwood Memorial Gardens* v. *Commissioner*, 350 F. 2d 225 (C.A. 7); *Thompson* v. *Commissioner*, 235 F. 2d 599 (C.A. 9). *Guardian Investment Corp.* v. *Phinney*, 253 F. 2d 326 (C.A. 5), is clearly inapplicable, holding as it does that an accrual basis taxpayer can deduct interest only in the year when he becomes obligated to pay it. The petitioner cites also *Deputy* v. *du Pont*, 308 U.S. 488, 497–498 (Pet. 7), for definitions of "indebtedness" and "interest". There is nothing in the decisions of the lower courts which offends these definitions, which were correctly applied to the complex facts here.

Here, the lower courts looked through the form of the transaction as created by the draftsmen of the agreements and found that the practical circumstances underlying the transaction were such that Zeckendorf was effectively compelled to exercise the option (R. 28a; Pet. App. 12b). The exercise of the option was the only way for Zeckendorf to protect its $633,000 investment in Comtel, which had been subordinated to the interests of other stockholders; to protect its parent, Webb & Knapp, against a larger potential liability under the latter's agreement to indemnify the other stockholders; and to avoid losing the benefit of its own efforts and expenses in acquiring the Commodore stock from the public shareholders and in negotiating the financing transaction. Thus, even in the absence of an unconditional legal obligation to pay money, the lower courts were fully justified in characterizing the transaction as a loan as opposed to a sale. The "essence" of arrangements "is determined not by subtleties of draftsmanship but by their total effect." *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 266–267.

2. The court of appeals did not, as petitioners claim (Pet. 9–18), err in refusing to consider their contention that if the transaction amounted to a loan there would be no interest income but rather a tax-free original issue discount. Petitioners have throughout this litigation been represented by the same competent counsel. Their contention was made for the first time in a single paragraph of a lengthy appellate brief and without citation of authority. Petitioners in substance

argue that, whatever the circumstances, a court of appeals is obliged to consider any and every legal theory asserted on appeal but not at the trial level. But the courts of appeals plainly have discretion to refuse to entertain such arguments. *Hormel* v. *Helvering*, 312 U.S. 552. The Second Circuit just as plainly exercises that discretion according to the dictates of the particular circumstances of an individual case, as is demonstrated by the other Second Circuit cases—decided both before and after the present case—that petitioners cite (Pet. 14–15). The court of appeals in this circumstances, justifiably declined to consider the "bare bone explication" of this "novel contention" (Pet. App. 17b).[1]

[1] This "novel contention" is in any event without merit. Section 1232 of the 1954 Code classifies as a sale or exchange the redemption of certain debt instruments. The question sought to be raised by the petitioners is the meaning of the word "property" in Section 337(a). Section 1232 does not define "property" for purposes of Section 337. See *Central Building & Loan Assn.* v. *Commissioner*, 34 T.C. 447; cf. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54. See also Section 337(b). So far as our research reveals, petitioners' contention has not been raised in any other reported case and does not constitute a problem of importance in the administration of the tax laws. Moreover, this issue does not warrant review by this Court here because of the unique factual context in which it is raised.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 506

COMTEL CORPORATION, *et al.*,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONERS

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September 22, 1967.

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No. 506

REPLY BRIEF FOR THE PETITIONERS

Opinion Below

The opinion of the Court of Appeals is now officially reported at 376 F. 2d 791.

The First Question Presented

Respondent admits that there was in the instant case "the absence of an unconditional legal obligation to pay money" (p. 5), and that the court below decided "that there was a debt in the absence of a promise to repay" (p. 4). There can be no question, therefore, that the decision below is squarely in conflict with the legal premise upon which all the decisions cited at pp. 7-9 of the Petition were based—that there cannot be a debt for Federal income tax purposes (or for any other purposes) in the absence of an unconditional enforceable legal obligation to pay. That conflict cannot be reconciled by the assertion that Zeckendorf was "compelled" to exercise its option to purchase the Commodore shares. Such assertion means only that *at the time the option was exercised,* Zeckendorf believed that it was

more profitable to do so than not—a business decision that must be made by every holder of an option.

The Second Question Presented

Contrary to respondent's statement (pp. 5-6), petitioners do not contend that whatever the circumstances a court of appeals is obliged to consider any and every legal theory presented on appeal but not at the trial level. Petitioners contend, rather, that in the circumstances of this case—where a nonfrivolous legal argument is directed to an issue already present, no new evidence or findings of fact are required and the opposing party has had ample opportunity to respond—justice requires that the legal argument be considered by the court of appeals. That is the rule laid down by the decisions cited at pp. 13-17 of the Petition.* There is no room for discretion in that situation and *Hormel* v. *Helvering*, 312 U. S. 552 (1941), relied on by respondent, does not hold that there is. In *Hormel* this Court, while stating that ordinarily an appellate court considers only issues raised below, held that the court of appeals should have given and properly did give consideration to an argument made for the first time on appeal. And in a companion case, *Helvering* v. *Richter*, 312 U. S. 561 (1941), this Court reversed the decision of a court of appeals that had refused to consider the same argument made in *Hormel* and remanded the case so that the argument might be considered. Remand for the purpose of consideration of legal arguments not presented below was also ordered by this Court in *United States* v. *Shelby Iron Co.*, 273 U. S. 571 (1927).

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*Respondent has frequently been the beneficiary of that well established rule. Respondent's opposition to its application in the case of a private litigant is surprising.

The circumstances relied on by respondent in support of the refusal of the court below to consider petitioners' argument are that it was novel and was made in only one paragraph without citation of authority (pp. 5-6). Such objections are manifestly without substance. Is a new application of existing law thus to be ignored and brevity of expression thus condemned?

What valid purpose could be served by adopting respondent's position? Considerations of economy of judicial time and the orderly administration of justice are certainly not involved, for all the court below had to do was decide, on the basis of the facts before it and the arguments of counsel for both sides, whether petitioners' interpretation of the law was correct.* Petitioners ask this Court to remand the case to the Court of Appeals with directions to make that decision.

Respectfully submitted,

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September 22, 1967.

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*Although petitioners are not asking this Court to consider the merits of their alternative argument, it should be noted that respondent has not attempted any refutation of it other than the bald statement that it is "without merit." Respondent has, moreover, so misstated the argument as to make it unrecognizable (p. 6n). Petitioners are *not* raising any question as to the meaning of the word "property" in Section 337(a). The Tax Court and the Court of Appeals both held that the property owned by Comtel was a "debt" owing from Zeckendorf. If that is so, Section 1232(a)(2)(A) requires that any income realized by Comtel on the payment of that debt be considered as "gain from the sale or exchange of property". Since Section 337(a) exempts from tax "gain . . . from the sale or exchange . . . of property," Comtel is not taxable on such income.